

The Kentucky Division of Social Security *...leading the way*

Local Edition

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"Educate...then Audit"

IRS Targets Educational Institutions' 403(b) Deferred Comp Plans

Internal Revenue Service officials have told the Division of Social Security that the service intends to begin an initiative to improve compliance of 403(b) deferred compensation plans. The 403(b) plans are used mainly by employees of boards of education, universities and certain education agencies.

Representatives of the IRS will be participating in DOSS seminars during 2001 as part of their outreach efforts.

The following is a list of the IRS's most frequently encountered questions and answers regarding the 403(b) tax shelter annuity plans:

Q1. I am the payroll officer for a board of education and all I do is deduct salary deferrals from my employees' salaries and forward them to the annuity provider of their choice. Since the board does not "administer" the plan, I don't have any further responsibility, do I?

A1. The board of education is responsible for withholding the proper amount from employees' salaries for federal tax. If an employee exceeds the amount of contribution that can be properly deferred into the plan, the excess is income taxable to the employee.

The board could be subject to penalties for federal income tax withholding and FICA (if applicable) tax that should have been withheld on the excess contribution.

Q2. Our school system has a tax shelter annuity (TSA) for full-time teachers and administrative

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Less than \$2,500 in Quarterly Federal Employment Taxes May Now Be Deposited Quarterly

The Internal Revenue Service, in a step to simplify a major area of tax administration, will end monthly tax deposit requirements for about one million small employers. Beginning Jan. 1, 2001, many small employers are allowed to make employment tax payments on a quarterly basis, not monthly.

Under the new rules, the IRS will allow employers to make payments every three months if they have less than \$2,500 in quarterly employment taxes (federal income tax, social security and medicare). It replaces the current standard, which allows quarterly payments only if employers have less than \$1,000 in quarterly employment taxes. Some small employers who report more than \$2,500 must continue to make payments on their current schedules.

Small employers with employment taxes that are less than \$2,500 per quarter may pay the employment taxes when they file Form 941, "Employers Quarterly Federal Tax Return." With the publication of these regulations, only employers with employment taxes of \$2,500 or more per quarter must deposit the tax with an authorized financial institution.

The difference between the \$1,000 and \$2,500 thresholds affects payment requirements for about one million employers. Small employers deposit about \$6.6 billion, about 13 percent of the \$52.7 billion in total employment tax deposits. The previous threshold had been \$500 and was raised to \$1,000 on June 17, 1998. The IRS, after further study, produced regulations to further increase the threshold to \$2,500.

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403(b) FAQs

personnel. It is just too much administrative paperwork to extend coverage to part-time employees and substitute teachers. They wouldn't participate anyway, since they don't have a full-time salary. Do we have to cover part-time and substitute teachers in our salary deferral TSA?

A2. In order to meet nondiscrimination requirements of the law, once an plan sponsor permits any employee to elect a salary deferral into the TSA, the opportunity must be extended to all employees of the organization who may elect to make contributions of more than \$200 pursuant to a salary reduction agreement.

Certain employees may be excluded from TSA participation. Employees who may be excluded include employees who are participants in an eligible deferred compensation plan (457 or 401(k)) or participants in another TSA, nonresident aliens, certain students and employees who normally work less than 20 hours per week.

Special care should be taken to comply with this requirement. Noncompliance could result in the entire TSA losing its tax-favored treatment.

Q3. What are the most common compliance failures at boards of education or universities in tax shelter annuities that have been examined by IRS?

A3. The most common failures in TSA(s) are:

- (1) Universal Availability – failure to offer a salary reduction option to eligible part-time employees and substitute teachers, or
- (2) failure to comply with the Maximum Exclusion Allowance (MEA) limit, or
- (3) failure to comply with the salary deferral limit, or
- (4) failure to comply with the requirement that contributions be limited to the lesser of 25 percent of includible compensation or \$35,000 (\$30,000 for 2000).

Q4. I know there is an annual 25 percent of compensation limit on employer and employee contributions to my TSA. My employer doesn't contribute to the TSA. All contributions are my salary deferral contributions. I make \$30,000 and I would like to make the maximum salary deferral contribution of \$10,500 to my account. Can I contribute the full \$10,500 since my employer doesn't make an employer or matching contribution?

A4. There are three contribution limits that apply to TSA(s). In any given year, your contribution is limited to the least of these three limits. The three limits are:

- 1) the maximum exclusion allowance (a cumulative contribution limit),
- 2) the annual dollar limit on elective deferrals which is generally \$10,500 for the years of 2000 and 2001, and
- 3) the annual contribution limit on employer and employee contributions (generally the lesser of 25 percent of compensation or \$35,000 for 2001 (\$30,000 for 2000)).

Applying the annual contribution limit would limit your contribution to 25 percent of your compensation or \$8,750 for 2001. Your contribution may be further limited by the maximum exclusion allowance. You may be eligible to make certain elections that may permit an increase in your contribution amount.

The Commonwealth of Kentucky does not discriminate on the basis of race, color, national origin, sex, religion, age or disability in employment or the providing of services and will provide, upon request, reasonable accommodation including auxiliary aids and services necessary to afford individuals with disabilities an equal opportunity to participate in all programs and activities.

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New IRS Regulations Address Electronic Forms W-2

The Internal Revenue Service recently announced, in IR 2001-20, that providers of certain information statements, including Form W-2, now have the option of giving employees the information electronically instead of on paper. Employers are currently required to provide information statements in written form -- generally on or before January 31. Under the temporary regulations, a person required to furnish a copy of a Form W-2 to an employee may furnish the form when it is provided electronically on a Web site instead of on paper if certain conditions, described below, are met.

The rules attempt to accommodate both filers and recipients. Some employers furnishing statements want to reduce costs and modernize business processes. Some recipients want to receive electronic statements to file income tax returns quickly and accurately. The rules also accommodate employees who want paper statements. These employers may choose to continue to receive paper statements.

Generally under the regulations, an employer that is required to furnish a statement is treated as timely furnishing it to an employee for federal tax purposes if the employee electronically consents or electronically agrees to receive the statement electronically, and the employer:

- 1) discloses certain information to the employee at or before the time the employee consents to receive the statement electronically;
- 2) posts the statement on a web site on or before January 31 and maintains access through October 15 of the year after the year to which the statement relates; and
- 3) notifies the employee on or before January 31 of the year after the year to which the statement relates that the statement is available on a web site.

The new regulations apply to copies of Forms W-2 that are required to be furnished to employees after December 31, 2000. The temporary regulations do not change the rules for filing Forms W-2 with the Social Security Administration.

You may view the temporary regulations that were published in the February 14, 2001 issue of the Federal Register on the IRS web site at <http://ftp.fedworld.gov/pub/irs-regs/td8942.pdf>.

Please call 502/564-3952 if you have any questions or require additional information.

Adoption Benefits

Amounts paid or expenses incurred by an employer for qualified adoption expenses under an adoption assistance program are not subject to income tax withholding and are not reportable in box 1 of the Form W-2. These amounts are, however, subject to social security and medicare taxes, if the employee is covered, and must be reported in box 3 and box 5 of the Form W-2. This includes adoption benefits paid from a section 125 (cafeteria) plan, but does not include adoption benefits forfeited from a cafeteria plan.

Also, the total amount must be reported in box 13 of the Form W-2 with code T.

An employee who receives reimbursement or payment that does not qualify for exclusion from gross income, or only partially qualify, must make an appropriate adjustment on Form 1040 to include in gross income the taxable portion of the reimbursement. In addition, the employee may need to make an adjustment to his or her income tax withholding (on Form W-4) or make estimated tax payments to avoid penalties for underpayment of tax on the taxable portion of the reimbursement.



Federal Income Tax Withholding on Nonresident Aliens

In general, if you pay wages to nonresident aliens, you must withhold income tax, unless excepted by regulations, as you would for a US citizen. Income tax withholding from the wages of non-resident aliens is, however, subject to the special rules shown below. You must also give a Form W-2 for these wages to the nonresident alien and file it with the SSA.

Form W-4 When completing Form W-4 nonresident aliens are required to:

- Not claim exemption from income tax withholding.
- Request withholding as if they are single, regardless of their actual marital status.
- Claim only one allowance (if the non resident alien is a resident of Canada, Mexico, Japan, or Korea, he or she may claim more than one allowance).
- Request an additional income tax withholding amount, depending on the payroll period, as follows:

Payroll Period	Additional Withholding
Weekly	7.60
Biweekly	15.30
Semimonthly	16.60
Monthly	33.10
Quarterly	99.40
Semiannually	198.80
Annually	397.50
Daily or Miscellaneous	1.50

(each day of the payroll period)

Note: *Nonresident alien students from India are not subject to the additional income tax withholding requirement.*

FICA Tax Withholding on Non-Resident Aliens

The FICA status of a nonresident alien depends on the coverage applicable to the government employer, the visa type, the purpose for which the alien entered the US and the length of time the alien has been in the US.

Generally, the following visa types are excluded from FICA taxes, both social security and medicare: "F", "J", "M" and "Q". All visa holders with other visa classifications are usually subject to FICA tax withholding.

Additionally, foreign students with visa types "F-1", "J-1", "M-1" and "Q-1" who have been in the US more than 5 calendar years are generally subject to FICA tax withholding. Foreign scholars, teachers, researchers, trainees and other non-students with visa types J-1 or Q-1 who have been in the US more than 2 calendar years also are generally subject to FICA withholding.

See Pub. 515, *Withholding of Tax on Nonresident Aliens and Foreign Corporations*, and Pub. 519, *U.S. Tax Guide for Aliens*, for exceptions to these general rules.

What is a Section 218 Agreement?

Kentucky's local government agencies provide social security coverage, generally, for their employees by entering into a Section 218 Agreement with the Kentucky Division of Social Security. A Section 218 agreement is a written contract that provides social security and/or medicare coverage to some or all employees of the agency.

Once a Section 218 Agreement is enacted, any services performed by an employee will be covered, unless specifically excluded in the agreement. Coverage may not be terminated once enacted under a Section 218 agreement.

To determine if your agency is covered under a Section 218 Agreement, or needs to execute one, contact the Division at 502/564-3952.

WHO IS A GOVERNMENTAL EMPLOYEE FOR FEDERAL TAX PURPOSES?

Elected and appointed officials are considered officers and therefore employees of their political subdivision for federal employment tax purposes. Such local, Kentucky officials include, but are not limited to mayors, city council/commission members, school board members, conservation district supervisors, any board/commission/authority members appointed by the city or county. Wages paid these employees should be reported, at the end of each calendar year, on Form W-2, not Form 1099.
